Regulation and Competition in Cable Television

Albert K. Smiley†

Under the Cable Communications Policy Act of 1984 (the Cable Act),[1] municipal regulation of rates for cable television service has been effectively preempted by the FCC for the vast majority of domestic cable systems.[2] At the same time, the Cable Act affirmed the right of each municipality to "award . . . one or more franchises within its jurisdiction." In addition, "a cable operator may not provide cable service without a franchise."[3] Thus, in a single stroke, the federal government eliminated local rate regulation and granted municipalities the power to control entry and award *de facto* monopoly franchises.

This landmark policy decision created a rather unusual regulatory environment for cable television. Typically, in regulated industries with pronounced economies of scale or scope, state or local regulatory authorities have the power to grant monopoly franchises to firms in return for a commitment from the firm to serve all comers at reasonable rates to be determined by the franchising authority. Thus, under the typical "social contract," the regulated firm acquires a monopoly franchise, but surrenders the power to set the terms of service. In the cable industry, however, federal preemption of local rate-regulation authority prevents municipalities from directly constraining the market power of incumbent monopolists by setting rates. Moreover, since contractual restrictions on rates are preempted as well, municipalities are unable to promote Demsetzian "competition for the market" by requiring cable operators to bid for franchises on the basis of a contractual commitment to future rates.[4]

† Albert K. Smiley, President and Chief Executive Officer of Smiley Brothers, Inc. and former Director of Research for the Economic Analysis Group, Antitrust Division, U.S. Department of Justice. Princeton University, Ph.D. 1978. The author would like to thank Timothy Brennan, Marius Schwartz and Robert Willig for helpful comments. The views expressed herein are not purported to represent those of my colleagues or employers.

1. 47 U.S.C. §§ 152, 224, 309, 521-22, 531-33, 541-47, 551-59, 605, 601-11 (Supp. V 1987).
2. *Id.* at § 543.
3. *Id.*
4. *See* Demsetz, *Why Regulate Utilities?*, 11 J.L. & ECON. 55 (1968).

In his timely Article on overbuild competition and franchising policy, Thomas W. Hazlett focuses on the potential impact of an open entry policy in encouraging more widespread direct competition among cable television systems, constraining rates, and improving service.[5] Hazlett applies public choice theory to analyze the welfare effects of the municipal franchising decision.[6] He hypothesizes that municipal franchising authorities generally will have an incentive to grant monopoly franchises to incumbent cable operators in exchange for side payments to municipal officials and political pressure groups.[7] Hazlett claims that open entry and competition would make consumers and society better off in terms of economic welfare, but that municipalities will rarely opt for such a policy. He suggests that, absent municipal control over franchising, potential and actual competition would be much more widespread and would be a significant factor in constraining rates and improving service.[8] Finally, he argues that given rate deregulation, society would be better served by a uniform policy of open entry, which implies a need for preemption of municipal franchising authority.[9]

The major contribution of Hazlett's work is to call attention to the anomalous regulatory environment embodied in the Cable Act. It is indeed unusual for local regulatory authorities to be empowered to create franchise monopolies without having any concomitant power to constrain rates. Clearly, the combination of regulatory provisions contained in the Act entails a significant risk that some municipal franchising authorities will sell out consumer interests by awarding exclusive franchises to cable operators in return for side payments.

However, major criticisms of Hazlett's position can be made. First, his public choice analysis is too one-sided in that it completely discounts the possibility of municipal responsiveness to consumer interests. Second, his analysis of the welfare effects of municipal franchising and overbuild competition is flawed in that he underestimates the potential for open entry to reduce welfare and consumer's surplus under certain market conditions. Third, he fails to present convincing evidence that, absent municipal franchising authority, potential and actual entry would effectively constrain rates in most domestic cable markets. Moreover, even in markets where

5. Hazlett, *Duopolistic Competition in CATV: Implications for Public Policy*, 7 YALE J. ON REG. 65 (1990).
6. *Id.* at 80-84.
7. *Id.* at 85.
8. *Id.* at 113.
9. *Id.* at 114-19.

entry can occur, significant practical problems remain which may require some sort of municipal intervention. Fourth, to give a complete answer to the central question posed by Hazlett (i.e. whether municipal franchising authority should be preempted), it is necessary to relax the assumption that federal preemption of local rate regulation is engraved in stone. In particular, since Hazlett's open entry policy might require a revision of the Cable Act to preempt municipal franchising, it is appropriate to consider modification of the ratemaking provisions of the Act as well.

I. Public Choice Analysis

The core of Hazlett's analysis is his public choice model of municipal franchising behavior. Hazlett argues that individual voters are likely to be ignorant of the potential benefits of overbuild competition and that the transaction costs of organizing consumers to monitor the performance of franchising authorities are prohibitively high. As a result, municipal authorities have an incentive to grant a monopoly franchise to a single operator in exchange for side payments in cash and in kind, which are then distributed to various special interest groups in exchange for political support. Thus, in Hazlett's scenario, municipal authorities completely discount the benefits of competition to consumers. Hazlett concludes that incumbent cable operators generally can induce franchising authorities to erect barriers to entry through the franchising process.[10]

A. *Conceptual Problems with Hazlett's Model of Public Choice*

In evaluating Hazlett's argument, it is important to keep in mind several features of cable television markets. First, cable service is a highly visible product about which consumers are likely to be well informed. Second, consumers have one important political advantage over incumbent operators and special interest groups: they have more votes. Third, once a cable operator has built its system, it is essentially trapped in the market because the salvage value of cable plant is practically nil. This gives municipal authorities a chance to behave opportunistically by allowing additional entry after the incumbent has been led to believe that it has paid off the authorities to acquire a monopoly franchise.

10. *Id.* at 82.

Despite the superficial appeal of Hazlett's argument, there is no compelling theoretical case that consumer ignorance and transaction cost asymmetries will generally lead to the successful manipulation of municipal franchising decisions by incumbent operators. One could just as easily argue that municipalities would tend to opt for too much competition, in terms of total welfare maximization, because they would weigh the interests of their primary voting constituency—consumers—too heavily and discount the increased costs and lower profits of cable operators. Hazlett's entire public choice argument is based on the unsupported assumption that municipal franchising authorities have insufficient political incentives to promote competition. Thus, the outcome he postulates is completely conjectural.

B. *Empirical Evidence on Municipal Franchising Practices*

Absent a compelling theoretical case, the extent to which incumbent operators influence franchising decisions and successfully deter entry is an empirical question. I am not aware of any compelling empirical evidence that municipal authorities generally seek to prevent overbuild competition. Instead, what we observe is that there are very few overbuilds.[11] There are at least two plausible explanations of this phenomenon: the public choice explanation given by Hazlett and the conventional explanation that overbuild competition is simply uneconomic in most markets because of pronounced economies of scale and scope in providing cable television service within a given geographic area.[12]

Hazlett's assertion that municipalities routinely seek to impede competitive entry is supported by anecdotal evidence involving several overbuilds in Florida and Sacramento.[13] However, in an industry with over 7,000 cable systems, and given the idiosyncrasies of local regulators and maverick operators, it is possible to find

11. *See id.* at 65 ("exclusive franchises are the overwhelmingly dominant market structure in the cable television industry").

12. *See* Noam, *Economies of Scale in Cable Television: A Multiproduct Analysis*, in VIDEO MEDIA COMPETITION 93 (1985).

13. *See* Hazlett, *supra* note 5, at 90-113.

anecdotes to support almost any proposition.[14] Thus, anecdotes tell us little about how franchising authorities generally behave.

The empirical evidence presented by Hazlett to support his theory of public choice is sketchy. Zupan found that cable operators often add costly special features to their systems, presumably to help them obtain franchises.[15] However, Zupan's study also shows that municipal rate regulation significantly constrained prices, which appears to be inconsistent with Hazlett's public choice analysis.[16] Hazlett argues, based on his unpublished study of rate deregulation in California, that "local price controls were not used to enhance consumer welfare . . ., but were used primarily as leverage by governments to enforce cross-subsidy agreements between firms and franchisers."[17] It is not clear why municipalities would need to use rate controls as an enforcement mechanism since they could threaten to award a second franchise if the required cross-subsidies were not forthcoming.

At most, Hazlett's evidence shows that some municipal governments have elected to oppose entry by would-be overbuilders. However, it is overreaching to conclude that, "[e]ntry will be deterred not because of natural monopoly conditions, but because municipal franchisers do not adequately consider consumer interests."[18]

14. For example, an article in the cable trade press noted that:

> city councils which, faced with a new era of powerlessness as a result of the Cable Communications Policy Act, have begun looking on second franchises, or at least the threat of them, as a method to exert control over cable companies in the form of price competition and provision of services. However, while the threat of an overbuild has worked in many cases to move established operators toward rebuilding their systems, in most cases where cities have actually invited a second bidder into the market, they have met with failure. John Witt, city attorney for San Diego, noted that despite that jurisdiction's attempts over the past year to attract additional cable operators to that market, there have been no responses to the city's request for proposals. That experience has been repeated in Erie, Pa., where the ATC system has been battling with the city council over rates and in several other locations around the country. The experience these cities have had with seeking overbuilds and their inability to attract new cable operators points up a fundamental attitude about overbuilds in the cable industry—they are basically uneconomic.

Kahn, *How Safe Is Cable's 'Natural Monopoly'?*, Cablevision, Oct. 13, 1986, at 60. Obviously, the San Diego and Erie experiences related in the article appear to be inconsistent with Hazlett's public choice analysis.

15. Zupan, *The Efficacy of Franchise Bidding Schemes in the Case of Cable Television: Some Systematic Evidence*, 32 J.L. & ECON. 401 (1989).

16. If Hazlett's theory of public choice were correct, municipalities would have an incentive to set rates at the monopoly level to maximize the potential side payments from the franchisee.

17. Hazlett, *supra* note 5, at 74.

18. *Id.* at 82.

II. Analysis of Welfare Effects

Traditional cost/benefit analysis of overbuild competition suggests that the welfare effects of overbuilds are ambiguous because the increased costs of duplicated facilities must be balanced against the increase in consumer surplus caused by the lower prices and the greater product variety resulting from direct competition.[19] Hazlett criticizes this approach on the grounds that it treats the incumbent's sunk costs as marginal social costs, lacks a "plausible public choice model of the municipal decision to award cable franchises," and "fails to allow profit-maximizing firms to internalize rationally the costs of duplication."[20] I will consider each of these points in turn.

A. *Sunk Costs and Marginal Social Costs*

Hazlett argues that, in the case of sequential entry, the initial entrant's fixed investment is largely sunk and therefore irrelevant in analyzing welfare effects and determining optimal public policy.[21] This would be true if the only policy objective were to maximize incremental welfare gains over the useful life of the cable system after initial entry has occurred. However, since the useful life of cable plant is about fifteen years, cable operators and municipalities face a continuing cycle of plant depreciation, rebuilds, upgrades, and refranchising decisions. Contrary to Hazlett's presumption, today's sunk costs become tomorrow's marginal social costs. Moreover, the focus of the public policy debate should be on determining a franchising policy that will maximize social welfare in the long run, rather than on the myopic maximization of short-run welfare gains during one franchising cycle after initial entry occurs. Thus, the sunk costs of the initial entrant are relevant to the social welfare calculus of overbuild competition with sequential entry.

19. *See* SMILEY, ANTITRUST DIVISION, U.S. DEP'T OF JUSTICE, DIRECT COMPETITION AMONG CABLE TELEVISION SYSTEMS (EAG Paper No. 86-9, June 5, 1989) (an application of the traditional approach).

20. Hazlett, *supra* note 5, at 77.

21. *Id.* at 77-80.

B. *Public Choice Considerations and Rent Dissipation*

Hazlett's second criticism of the traditional cost/benefit approach is based on his public choice model.[22] He notes that the potential welfare gains from preventing overbuild competition arise from the increased profits of the incumbent and argues that these "gains are easily appropriated by the franchising authority . . ., and then dissipated in the ensuing quest for private assignment."[23] Thus, under Hazlett's public choice scenario, the incumbent generally will be granted a monopoly franchise and wasteful rent-seeking approximately equal to the monopolist's gains will result. Hazlett concludes that the franchising process is "nakedly inefficient from a welfare perspective."[24]

Even if monopolists do transfer monopoly rents to public officials, it is unclear what portion of the monopolist's incremental profits is dissipated in inefficient rent-seeking activities, such as unneccessary consultants' studies, and what portion is transferred to franchising authorities and special interest groups as side payments of cash and kind. Presumably, a significant portion of the monopoly rents must be transferred if the incumbent is to outbid consumers and would-be entrants for the allegiance of the municipal authorities in the public choice equilibrium postulated by Hazlett. These transfers may not be desirable from a distributional perspective, but they should not be counted as welfare losses since they are captured by the recipients.

Hazlett also concludes that an open entry policy can never reduce consumer surplus, regardless of whether entry actually occurs.[25] This proposition is certainly not always true and may not even be true in most cases. If entry is effectively foreclosed by an incumbent with a first-mover advantage, the municipality may use its franchising authority to capture some portion of the monopoly rents for its constituent consumers by requiring additional system features and franchise fees.[26] Indeed, since municipal rate-making authority generally is preempted under the Cable Act, requiring system features and franchise fees is likely to be the municipality's only

22. *See id.* at 80-84.
23. *Id.* at 84.
24. *Id.* at 86.
25. *Id.*
26. The modern literature on strategic entry deterrence is replete with demonstrations that, in an industry with significant fixed costs, a firm with a first-mover advantage may be able to foreclose subsequent entry by making an initial sunk-cost investment in plant. *See, e.g.*, Dixit, *The Role of Investment in Entry Deterrence*, 90 ECON. J. 95 (1980). This analytical paradigm is applied to the cable industry in SMILEY, *supra* note 19, at 11-17.

means of increasing consumer surplus at the monopolist's expense. Hazlett correctly points out that transfers in kind tend to be less efficient than pure cash transfers or price reductions because the costs to the operator are likely to exceed the benefits to consumers. Still, the possibility remains that in markets where overbuild competition is not economically viable, municipalities can use their franchising authority to extract some benefits for consumers. To argue that this process is inefficient is as much a criticism of the rate deregulation provisions of the Cable Act as it is a criticism of municipal franchising practices.

C. *Private Rationalization of Cable Service*

Hazlett argues that any inefficiencies of an open entry policy, such as rent dissipation in a race to build preemptively or excessive duplication of cable plant, can be internalized and minimized by rational entrants using measures such as limit pricing, sustainable pricing, mergers of competitors, and gentlemen's agreements among potential competitors on territorial restrictions.[27] I will defer my discussion of the likelihood and credibility of entry-deterring pricing until the next section. The likelihood of welfare-enhancing agreements among competitors and the possible nonexistence of sustainable prices are discussed below.

1. *Agreements Among Competitors*

Relying on mergers and "gentlemens' territorial agreements" among competitors to rationalize entry and production without suppressing competition requires either a great deal of faith in the altruism of cable operators or an extremely enlightened and effective antitrust policy. One of the difficulties in evaluating Hazlett's proposal for open entry is that the conditions under which potential and actual competitors would be allowed to enter "gentlemen's agreements" or merge are not clearly specified. I am unconvinced that the rationalization of production by private action is as straightforward as Hazlett suggests. Indeed, I suspect that many of the conflicts and ambiguities of franchising policy would resurface as antitrust problems under an open entry policy.

Hazlett suggests that an efficient open entry policy may require the municipality to sponsor gentlemen's agreements among firms

27. Hazlett, *supra* note 5, at 84 n.81.

on initial territorial restrictions in order to avoid excessive plant duplication and rent dissipation in an inefficient race to build.[28] He gives an example of the apparently successful implementation of such agreements in Dade County, Florida.[29] According to Hazlett, the county ultimately reneged on its pro-competitive policy, which is consistent with Hazlett's rather pessimistic view of public choice.

The Dade County incident illustrates an interesting practical problem with Hazlett's approach. It appears that some municipal intervention was necessary in this case in order to get the competitive process started and have it function effectively. However, if Hazlett's analysis of public choice is correct, it is hard to see why one would expect municipal management of territorial restrictions to promote the interests of consumers. Thus, if one accepts Hazlett's public choice model, one would expect open entry to suffer from many of the same defects that Hazlett attributes to the franchising process.

A similar problem exists with respect to the municipality's procedure for allocating building permits to competing cable operators. During the construction phase, municipal authorities are necessarily involved in issuing building permits to protect public health and safety. Since each permit is, in effect, a temporary mini-franchise, the municipality can still exercise significant control over the scope and pace of construction through the permitting process. Moreover, since entry can often be foreclosed by a firm with a first-mover advantage, and since a first mover is likely to enjoy significant pecuniary gains, would-be entrants are likely to compete for favorable treatment in obtaining permits. Conversly, building inspectors may be tempted to win favors from operators by expediting some permits and delaying others. In short, preemption of municipal franchising authority may simply shift many of the problems that Hazlett identifies from the franchising arena to the

28. Smiley has demonstrated that, in some markets, overbuild competition could be foreclosed by a first-mover, but competition would be viable if entry were allowed to occur in controlled stages. *See* SMILEY, *supra* note 19, at 24, 27 (Table 1 and accompanying text). In these markets, the municipality could avoid the monopoly outcome by dividing its franchise area into sections, awarding an initial franchise for each section to a different firm, and later permitting each firm to expand into the territories of the other firms. In effect, this practice rules out a preemptive complete build by the first entrant and preserves welfare-enhancing fringe competition among the franchisees. It also has the advantage of eliminating the welfare-reducing rent dissipation caused by an inefficient race to build, that is likely to occur if simultaneous, unrestricted entry is permitted. Thus, there exist cases where regulation of entry by municipal authorities can promote competition and increase consumer surplus and total welfare.

29. *See* Hazlett, *supra* note 5, at 95.

building inspector's office. Arguably, since potential conflicts of interest are inherent in the construction process due to first-mover advantages and the need for municipal health and safety regulation, it is better to confront them in the franchising process, which is relatively open to public scrutiny.

2. *Sustainability of Natural Monopoly in Cable Television*

Another potential problem with open entry is the possibility that in some markets, a welfare-maximizing natural monopoly may be unsustainable without regulatory prohibitions on entry.[30] Even if a single cable system is the lowest cost provider of service to a municipality made up of neighborhoods of differing population densities, it may not be able to deter entry and sustain its natural monopoly position by pricing alone. If a natural monopoly cable system cannot price discriminate among neighborhoods and within each neighborhood, entry by other systems that serve only the high density neighborhoods may deprive the natural monopolist of sufficient revenue to cover its fixed costs.[31] If selective entry, referred to as "cream skimming," persists, the natural monopolist will eventually exit, or not enter in the first place if it correctly anticipates the outcome, and the loss of consumer surplus in the low-density neighborhoods may exceed any gains in the high density neighborhoods. If open entry results in a net reduction in total welfare and consumer surplus, a strong case can be made for franchise protection.

Hazlett acknowledges the theoretical possibility of unsustainable natural monopoly, but argues that it is of no practical importance because profits of incumbent cable systems are high enough under rate deregulation to enable them to withstand entry. As evidence, he points to the fact that system market values are typically much higher than construction costs.[32] I suspect that Hazlett's conjecture is true for the average system, but it may not be true for systems that are closer to the margin of survival. In the latter case, entry

30. For a general exposition of the problem of unsustainable natural monopoly, see Falhauber, *Cross-Subsidization: Pricing in Public Enterprises*, 65 AM. ECON. REV. 966 (1975).

31. Hazlett notes that price discrimination is often constrained by statute. Hazlett, *supra* note 5, at 97 n.119. In addition, he argues that price discrimination and universal service requirements may be used by incumbents and municipalities to deter entry. *Id.* at 94, 97 n.119, 102, 109.

32. *Id.* at 96-99.

restrictions may still be necessary to maximize consumer surplus and welfare.[33]

All things considered, I stand by the conclusions of my previous study that the welfare effects of overbuilds depend on local supply and demand conditions and that generalizations about the appropriate role of overbuild competition are likely to be misleading.[34] Moreover, since neither Hazlett nor any other commentator has produced convincing evidence that municipal authorities routinely act in opposition to consumer interests in their franchising decisions, there is a significant likelihood that across-the-board preemption of municipal franchising authority would prevent some municipalities from adopting welfare-enhancing entry policies. This does not mean that municipal franchising is likely to improve welfare in all cases or even in most cases. Instead, it suggests that Hazlett's universal open entry policy has a potential downside that must be balanced against the speculative gains from more widespread overbuild competition.

33. A simple example will illustrate the problem of unsustainability. Suppose that a natural monopoly cable system can serve both a high and a low density neighborhood at a total fixed cost of $2 million. Assume that service to the high density and low density areas also can be provided separately at fixed costs of $0.75 million and $1.5 million respectively. For simplicity, assume that marginal costs are zero in all cases. The cable system is a natural monopoly because it can serve both areas for $0.25 million less than they can be served on a stand-alone basis. In addition, suppose that the natural monopolist charges the revenue-maximizing price in both areas, that revenue from each area is $1 million, and that consumer surplus in each area is $0.5 million. Note that the system's total revenues of $2 million just cover its fixed costs and that total consumer surplus is $1 million. If targeted entry is permitted in the high density area, residents may choose to take their service from an entrant serving only that area. Moreover, the natural monopolist would be vulnerable to entry by a stand-alone high density system because it could underprice the incumbent in the high density market. Recall that the incumbent derives revenues of $1 million from that market and that the entrant's costs will be only $0.75 million. If the incumbent matches the entrant's reduced price in the high density market, its total revenues will fall below $2 million and it will not cover its total fixed costs. Unless the incumbent can price discriminate in the low density market and extract enough additional consumer surplus there to cover its fixed costs while matching the entrant's price in the high density market, it will fail to earn a competitive return on its capital and eventually exit both markets when its plant wears out. Since the high density specialist needs to underprice the incumbent only slightly to drive the incumbent out, the consumer surplus gain in the high volume market will be very small. In contrast, stand-alone service in the low density market is not viable without price discrimination because maximum revenues are less than stand-alone fixed costs. Thus, the low density market will not be served, and its entire consumer surplus of $0.5 million is lost. Total consumer and producer surplus is now roughly $0.75 million, which is $0.25 million less than before entry.

34. SMILEY, *supra* note 19, 34-35.

III. Likelihood of Direct Competition

Hazlett argues that, under a universal open entry policy, potential and actual competition would be much more widespread and would be a significant factor in constraining rates. I am much less optimistic that competition would effectively constrain rates on a widespread basis if municipal franchising authority were preempted.

A. *Factors Affecting the Feasibility of Overbuild Competition*

Under open entry, the economic feasibility of overbuild competition depends on local supply and demand conditions. Since most domestic markets are already cabled, the would-be entrant must decide whether it will earn positive profits in the post-entry equilibrium. This in turn depends on the intensity of demand, the ability of the entrant to differentiate its product from the incumbent, the cost of cabling the community, and the strategic interaction between the two firms. The potential entrant can anticipate that the incumbent's price will be reduced in the post-entry equilibrium to meet the competitive challenge.

In spite of Hazlett's optimism concerning open entry, the general feasibility of overbuild competition is an empirical question. Using a wide range of simulated supply and demand conditions, Smiley found that an incumbent with a first-mover advantage can often foreclose entry by cabling the entire franchise area.[35] If it is difficult for the entrant to differentiate its service from that of the incumbent, entry is less likely to occur because prices are expected to be lower in the post-entry equilibrium when the two services are closer substitutes.[36]

In my previous study of overbuilding, I suggested that the entrant might differentiate its product from the incumbent by obtaining exclusive rights to programming.[37] However, achieving significant programming differentiation has proven to be difficult in practice. First, high quality programming is costly to produce and is in limited supply. Producers of this programming are anxious to reach as many consumers as possible. Hence, they are reluctant to award exclusive distribution contracts to new entrants that are likely

35. *Id.* at 31-33.

36. For a thorough analysis of the effects of product differentiation on the likelihood of entry, see Dixit, *A Model of Duopoly Suggesting a Theory of Entry Barriers*, 10 BELL J. ECON. 20, 20-22 (1979).

37. SMILEY, *supra* note 19, at 32 n.40.

to have smaller market shares. Second, it is unclear that consumers would welcome two differentiated systems, since they probably would prefer to have the entire menu of programming options available on one system so that they would not have to subscribe to both systems or switch back and forth. In short, the scenario of dueling, differentiated cable systems suffers from a fundamental credibility problem: programmers and consumers may not support it.

In overbuilt markets where the incumbent has adequate channel capacity, I suspect that the incumbent and the entrant often would wind up offering very similar slates of programming, i.e., the standard lineup of cable fare. However, when programming is relatively undifferentiated, it is less likely that post-entry equilibrium prices would be high enough to attract entry in the first place.[38]

B. *Empirical Evidence on Overbuilding*

Hazlett notes that the rate of entry is increasing in the 1980s, even though the number of overbuilds is still small in absolute terms. He suggests that potential and actual competition would be more prevalent were it not for franchise restrictions and predatory behavior by incumbents.[39] I would stress again that the prevalence of overbuilding under an open entry policy is an empirical question on which the jury is still out. The large percentage increase in the small number of overbuilds is not at all surprising, given the widespread deregulation of rates triggered by the Cable Act. One would expect that, in markets with relatively high demand and low construction cost where overbuilds are most likely to be economically viable, sudden rate deregulation would dramatically increase the probability of entry. However, it does not follow that overbuilds are economically viable in most markets, given rate deregulation.

Hazlett's conjectures about the feasibility of overbuilding are largely based on anecdotal evidence drawn from franchising disputes during the 1980s. This evidence may suggest that municipalities have occasionally tried to block entry or suppress competition, but it does not allow one to draw general conclusions about the feasibility of overbuilding under an open entry policy.

38. An exception to this dilemma occurs when the incumbent lacks adequate channel capacity to carry as much programming as the entrant. For an example of this in the Telesat case, see Hazlett, *supra* note 5, at 92-96.

39. Hazlett, *supra* note 5, at 112-13.

C. *Potential Entry, Contestability, Limit Pricing, and Schumpeterian Competition*

Hazlett argues that, under an open entry policy, actual overbuild competition may not be necessary to constrain rates and improve service because the threat of potential competition will do the job. He suggests several mechanisms that might induce incumbents to restrain prices and improve efficiency including "the contestability principle," the establishment of a credible, long-term commitment to an entry-deterring price, and Schumpeterian competition of successive monopoly firms.[40] Hazlett's optimism on this point does not appear to be well supported by either theory or empirical evidence.

1. *Contestability of Cable Television Markets*

The theory of contestability postulates that the incumbent's price will be effectively constrained in industries where hit-and-run entry is feasible. Hit-and-run entry requires that the entrant can enter and exit quickly and costlessly in response to a price increase or decrease by the incumbent.[41] In practical terms, this means that the entrant must incur no sunk costs and be able to enter and exit almost as quickly as the incumbent can change its price. Given the large sunk costs and time lags required to cable a city and the ability of the incumbent to adjust prices quickly under rate deregulation, it would be hard to find a more unlikely candidate for contestability than the cable industry.

2. *Limit Pricing*

Hazlett's conjecture that the incumbent will employ a long-run limit price to deter entry is dubious on theoretical grounds. The problem is that there is little reason to believe that the incumbent can make a credible, long-term commitment to an entry-deterring price because prices can easily be changed after entry occurs. Recognizing this, the potential entrant is likely to base its entry decision not on the incumbent's pre-entry price, but on the price expected to prevail in the post-entry duopoly equilibrium, assuming

40. *Id.* at 100-01.

41. *See* Schwartz, *The Nature and Scope of Contestability Theory*, 38 OXFORD ECON. PAPERS 37, 38 (1986).

profit maximizing behavior by each duopolist. Similarly, the incumbent recognizes that the potential entrant's decision is likely to depend only on the expected post-entry equilibrium price, which is determined by supply and demand conditions and the strategic interaction, and not on the incumbent's pre-entry price. Thus, the rational incumbent is likely to charge what the market will bear before entry occurs and to respond with selective price cuts only after entry actually occurs.[42]

The pricing scenario outlined above seems roughly consistent with the anecdotal evidence on overbuilds provided by Hazlett. In most cases, the standard response of the incumbent to an aggressive overbuilder seems to have been to employ price cuts targeted at areas where entry actually had occurred while keeping prices in other areas at higher levels.[43]

3. *Schumpeterian Competition*

I tend to agree with Hazlett that there is some hope for Schumpeterian competition whereby old monopolists are replaced by new ones in a process of creative destruction. However, because of my pessimism about the practicality of widespread overbuild competition, I believe that Schumpeterian competition is more likely to come from other technologies, such as high-definition direct broadcast satellite or fiber optic systems, than from conventional coaxial cable systems. Moreover, while the prospect of a technological revolution may be comforting in the long run, it will do nothing to provide relief from any extant supracompetitive pricing while cable remains the preeminent multichannel video distribution medium.

IV. Public Policy Options

The major thrust of Hazlett's argument is that, under rate deregulation, society would be better served by a universal policy of open entry. Since Hazlett's public choice model implies the reluc-

42. A complete discussion of the extensive literature on limit pricing is beyond the scope of this comment. A brief introduction and critique of the literature can be found in Schwartz, *supra* note 41, at 37-40. The strategic interaction of entry and pricing decisions described in the text is discussed and modeled in SMILEY, *supra* note 19, at 9-17.

43. Hazlett implies that targeted price cutting by the incumbent may be predatory. Hazlett, *supra* note 5, at 104-07. Note, however, that predatory pricing and competitive behavior are observationally equivalent: in both cases, the incumbent's price falls after entry occurs.

tance of municipalities to promote competition voluntarily, the implementation of an open entry policy at the federal level would require revision of the Cable Act to preempt municipal franchising authority. Hazlett's analysis of franchising policy is predicated on the assumption that federal law will continue to preempt municipal rate regulation.[44] However, once the issue of revising the Cable Act is opened, I would argue that it is more appropriate to consider cable policy in a broader context that allows for the possibility of some form of rate regulation. Indeed, judging by the latest news from Washington, D.C., Congress is currently giving more serious consideration to reinstituting rate regulation than to preemption of municipal franchising authority.[45]

A. *Alternative Regulatory Regimes*

If we consider cable policy in a broader framework, the four possible regulatory regimes are municipal regulation of rates and franchising (the previous regime), municipal franchising and the federal preemption of rate regulation (the current regime under the Cable Act), municipal rate regulation and federal preemption of franchising, and federal preemption of rate regulation and franchising (advocated by Hazlett). All but the third option are currently under serious discussion. Municipalities, consumer lobbying groups, and numerous congressmen have shown considerable interest in reregulating rates. Hazlett and prospective overbuilders such as Telesat advocate a *laissez faire* approach to rates and entry. Incumbent cable system operators appear to prefer the *status quo*.

As far as I am aware, the possibility of municipal rate regulation and federal preemption of franchising authority has never been seriously considered. Perhaps it should be. In theory, when current franchises expire, municipalities could conduct a Dutch auction for cable service by offering a sequence of increasing long-term rate caps

44. Hazlett notes that:

> Because federal law now prohibits local price control, the standard cost/benefit analysis has been simplified. The traditional economic approach evaluates monopoly franchise regulation by weighing the social benefits derived from controlling prices against the various costs associated with such a regulatory regime. This approach is clearly inappropriate when the regulators no longer control output prices.

Id. at 85.

45. Currently, there are several rate reregulation bills pending before Congress. *See* Pytte, *Cable TV: The New Big Kid Confronts Re-Regulation*, CONG. Q., Dec. 9, 1989, at 3361-3366.

until at least one cable operator, presumably the most efficient, stepped forward to apply for a building permit. This approach might answer some of Hazlett's objections to current franchising procedures because it would not allow municipal authorities to select the winner. At the same time, it might provide a more effective constraint on rates than complete *laissez faire*.[46] It suffices to say that it behooves economists who would influence the current debate over cable policy to include a broad range of alternative ratemaking and franchising regimes on the menu of policy options.

B. *Federal Preemption Versus Local Control*

Finally, Hazlett draws a parallel between First Amendment protection of freedom of speech and universal open entry, arguing that each of these policies "can best be understood as a calculated trade-off sacrificing regulatory flexibility for a higher mean market outcome, given all relevant constraints."[47] In particular, he argues that a discretionary municipal franchising policy may prove inferior to a uniform policy of open entry ". . . that, on average, gets it right."[48] I am troubled by the suggestion that federal preemption of local control is the appropriate response to the problems of the industry because it runs against the presumption that decisions involving economic regulation, including whether or not to regulate, should be vested in the political jurisdictions whose constituencies directly reap the benefits and bear the costs of those decisions. Since the primary economic consequences of cable regulation fall on local communities, this presumption suggests that regulatory authority over cable should rest with municipal governments.[49]

46. As with most regulatory regimes, this one suffers from its share of practical drawbacks. First, if only one entrant steps forward and subsequently fails to perform, the municipality would have to restart the process. Second, the price cap mechanism would eliminate some of the upward flexibility of rates and might suppress improvements in product quality. Third, municipal governments might have difficulty making a credible commitment to keep the price cap at the specified level in the long run. For a general discussion of the potential costs and benefits of price cap regulation, see Brennan, *Regulation by 'Capping' Prices*, 1 J. REG. ECON. 133 (1989).

47. Hazlett, *supra* note 5, at 117.

48. *Id.* at 116.

49. *See* Brennan, *Local Government Action and Antitrust Policy: An Economic Analysis*, 12 FORDHAM URB. L.J. 405 (1984); Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23 (1983). Brennan notes that "the theoretical presumption consistent with economic reasoning is that federal intervention in a matter affecting only the citizens within a smaller governmental unit is unwarranted." Brennan, *supra*, at 409. He then identifies three possible justifications for intervention that may overcome the presumption: economies of expertise, maintaining procedural integrity, and external effects on parties outside the

Federal preemption of municipal regulation does not necessarily eliminate government influence from cable markets. Instead, it merely substitutes federal influence for municipal influence, which should come as cold comfort to advocates of *laissez faire*. Recall that the current regime of deregulated rates and monopoly franchises, which Hazlett finds so unsatisfactory, was crafted by the United States Congress and the FCC, not by municipal governments. Indeed, the municipal public choice problem identified by Hazlett is likely to be exacerbated by federal preemption of cable policy. Hazlett correctly points out that cable operators acted opportunistically against municipalities and consumers in securing federal passage of the Cable Act,[50] which had the effect of abrogating thousands of contractual rate commitments that had been freely entered into by cable operators in the pre-deregulation era.[51] This episode suggests that the difficulty of organizing consumers to protect their interests in the arena of federal policymaking for cable may be even greater than at the municipal level.

Hazlett cites Kahn's devastating critique of the ICC's regulation of the trucking industry to support the notion that regulation often results in needless restrictions on entry.[52] It is unfortunate that we have no assurance that Congress and the FCC will do a better job of rewriting the competitive rules for the cable industry than the ICC did for trucking. In short, we must ask ourselves whether local cable regulation, while highly imperfect, is likely to be welfare-enhancing relative to federal preemption.

In summary, while I agree with Hazlett that the regulatory regime created by the Cable Act is highly unsatisfactory, I am skeptical of his public choice model and unconvinced that an open entry policy alone would effectively constrain rates in most domestic cable markets. Moreover, I remain convinced that the potential inefficiencies of overbuilds create a significant downside for an open

locality. *Id.* at 409-19. Since local cable franchising decisions are unlikely to have a major economic impact on parties outside the municipality and since federal authorities are not notably better than local authorities at conducting cost/benefit analysis of options for cable service in local markets, the major justification for federal preemption of franchising authority would have to be Hazlett's public choice argument that municipal franchising lacks procedural integrity because municipal authorities fail to represent consumer interests. Note that this paradigm does not address the case where municipal regulation violates some inalienable constitutional right such as freedom of speech.

50. Hazlett, *supra* note 5, at 89.

51. Although the Cable Act is commonly described as deregulatory, it could be viewed as the imposition of federal regulation on a previously unregulated market for cable service procurement between municipalities and cable operators.

52. Hazlett, *supra* note 5, at 115 n.178.

entry policy in some markets. In my view, the net welfare effects of a universal open entry policy with no other changes in federal regulation remains an open question. However, even if I were sure that universal open entry would be welfare-enhancing, I would question the wisdom of complete federal preemption of cable regulation. Instead, I believe it is more productive to consider cable policy in the context of a broader menu of regulatory options.